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TAX INCENTIVES FOR EDUCATION

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FINANCE

ON

MARCH 15, 1988

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

MARCH 14, 1988

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CONTENTS

	Page
INTRODUCTION	1
I. SUMMARY	2
II. DESCRIPTION OF PROPOSALS	6
A. Education Savings Bonds	6
B. Education Savings Accounts	9
C. National Education Savings Trust	12
D. Deduction for Interest on Education Loans	14
E. Employer-Provided Educational Assistance	16
F. Certain Student Loan Bonds	17
III. ECONOMIC ANALYSIS	20
A. Education Savings Bonds; Education Savings Accounts; Education Savings Trust	20
B. Deduction for Interest on Education Loans	28
C. Employer-Provided Educational Assistance	30
D. Certain Student Loan Bonds	31
APPENDIX: Direct Aid to Students for Post-Secondary Education	33

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on March 15, 1988, on tax incentives for education. This pamphlet,[1] prepared by the Staff of the Joint Committee on Taxation, provides a description of certain proposals for education tax incentives and an analysis of issues relating to such proposals.

The first part of the pamphlet is a summary of present law and the proposals. The second part describes present law and proposals relating to education savings bonds, education savings accounts, National Education Savings Trust, interest deduction on education loans, employer-provided educational assistance, and certain student loan bonds. The third part is an analysis of issues relating to such proposals. An Appendix provides information on direct aid to students for post-secondary education.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Incentives for Education*, (JCS-5-88), March 14, 1988.

I. SUMMARY

Education Savings Bonds

Present law

Present law does not include an exclusion from gross income, or deferral of taxation, for interest or other income specifically because the taxpayer uses the income for educational expenses. Taxation of interest accruals on U.S. Series EE savings bonds may be deferred by cash-basis taxpayers as long as the bonds are not redeemed.

S. 1817 (Senators Kennedy and Pell)

Interest income on a qualified U.S. savings bond would be excluded from income when such bonds are transferred to an eligible educational institution as payment for the higher education expenses of a taxpayer, taxpayer's spouse, or dependents. The exclusion would be phased out for taxpayers with adjusted gross income between $75,000 and $150,000.

The bill would apply to transfers of qualified U.S. savings bonds issued after the date of enactment.

S. 1662 (Senators Dole, Chafee, Danforth, Durenberger, Heinz, and Wallop)

This bill would authorize issuance of educational savings bonds (a special form of Series EE bonds) at the prevailing Federal long-term rate. A taxpayer could purchase annually for the benefit of a dependent up to $1,000 of such bonds on which interest would accrue tax-free. The accrued interest would be excluded from income in the year of redemption if used for higher education expenses. The interest exclusion would apply only if the taxpayer holds the bonds for at least one year, and not more than 20 years, after issuance.

The bill would apply for taxable years beginning after December 31, 1986.

Administration proposal

The President's budget proposals for fiscal year 1989 include a recommendation to exclude from gross income the interest on certain U.S. savings bonds that are redeemed to pay post-secondary educational expenses of the taxpayer or the taxpayer's spouse, children, or other dependents. The exclusion would be phased out for taxpayers with adjusted gross income above certain levels.

The exclusion would apply to bonds issued after December 31, 1988.

Educational Savings Accounts

Present law

Present law does not provide a specific deduction, credit, or income exclusion for amounts contributed to a trust to fund education expenses of the taxpayer or a child of the taxpayer.

S. 1533 (Senator DeConcini)

Taxpayers would be allowed an above-the-line deduction for cash contributions (up to $1,000 per year) made to an education savings account established to pay for future education expenses of the taxpayer or a dependent at an institution of higher education or vocational school. The deduction would be reduced for taxpayers with adjusted gross income above certain levels, similarly to the phaseout of the IRA deduction. Income earned by the education savings account generally would be exempt from taxation.

The bill would be effective for taxable years beginning after December 31, 1986.

S. 1659 (Senators Dole, Chafee, Danforth, Durenberger, Heinz, and Wallop)

This bill includes provisions for educational savings accounts that generally are the same as the provisions in S. 1533, as summarized above. However, S. 1659 would allow a 15-percent tax credit (up to $150 per year), rather than a deduction, for amounts paid in cash and the fair market value of stocks, bonds, or other readily tradeable securities transferred to an education savings account.

S. 1660 (Senators Dole, Chafee, Danforth, Durenberger, Heinz, and Wallop)

This bill is the same as S. 1659, except that no credit or deduction would be allowed for contributions to an education savings account. Earnings on amounts transferred to such account generally would not be taxable unless distributed for noneducational purposes.

S. 1661 (Senators Dole, Chafee, Danforth, Durenberger, Heinz, and Wallop)

This bill is the same as S. 1659, except that, for each taxable year, a 15-percent tax would be imposed on the taxable income of an education savings account, i.e., the gross income of the account minus any deductions directly allocable to such income.

National Education Savings Trust

Present law

Under present law, there is no provision that permits deductions for amounts contributed to a national trust to fund education expenses of the taxpayer or a child of the taxpayer.

S. 1572 (Senators Pell, Kennedy, and Stafford)

This bill would establish a public corporation, the National Education Savings Trust, which would enter into advance tuition payment plan agreements with taxpayers. Amounts paid by a taxpayer to the Trust pursuant to such an agreement would be deductible by the taxpayer up to $2,000 per year; the deduction would be reduced for taxpayers with adjusted gross income above certain levels. Amounts paid by the Trust to post-secondary education institutions would not be subject to Federal income tax.

Interest Deduction on Education Loans

Present law

Pursuant to the Tax Reform Act of 1986, the itemized deduction for personal interest (including interest on student loans) is being phased out over 1987-1990.

S. 628 (Senators Grassley, Danforth, D'Amato, Kerry, Durenberger, and Hecht)

The bill provides that interest on loans incurred for qualified education expenses would be deductible as an itemized deduction, effective for taxable years beginning after December 31, 1986.

Employer-Provided Educational Assistance

Present law

An employee must include in income and wages, for income and employment tax purposes, the value of educational assistance provided by an employer to the employee, unless the cost of such assistance qualifies as a deductible job-related expense of the employee. Under prior law (Code sec. 127), an employee's gross income and wages for income and employment tax purposes did not include amounts (up to $5,250 per year) paid or incurred by the employer for educational assistance provided to the employee if such amounts were paid or incurred pursuant to an educational assistance program that met certain requirements. The section 127 exclusion expired for taxable years beginning after December 31, 1987.

S. 39 (Senators Moynihan, Heinz, Boren, Pryor, Matsunaga, and Riegle)

The bill would reinstate the section 127 exclusion, effective as of its expiration date, on a permanent basis.

Certain Student Loan Bonds

Present law

Present law includes a special rule permitting qualified scholarship funding corporations (rather than States or local governments themselves) to issue tax-exempt student loan bonds in connection with the Federal Guaranteed Student Loan (GSL) or PLUS programs. Present law further includes two special exceptions providing (1) that issuers of tax-exempt student loan bonds issued in connection with these Federal programs may invest bond proceeds to earn arbitrage profits for a longer temporary period than applies to similar types of bonds and (2) that all or a portion of these arbitrage profits are exempt from the rebate requirement generally applicable to all other tax-exempt bonds. These two arbitrage exceptions are scheduled to expire with respect to bonds issued after December 31, 1988.

S. 2149 (Senators Mitchell, Pryor, Durenberger, Boren, Danforth, and Rockefeller)

The bill would permit qualified scholarship funding corporations to issue State supplemental student loan bonds, which are student loan bonds not subject to the restrictions of or receiving the benefits of the Federal GSL or PLUS programs. Also, the bill would make permanent the two special arbitrage exceptions and would extend these provisions to issuers of supplemental student loan bonds.

II. DESCRIPTION OF PROPOSALS

A. Education Savings Bonds

Present Law

Present law does not include an exclusion from gross income, or deferral of taxation, for interest or other income specifically because the taxpayer uses the income for educational expenses.

Certain types of investment income are excluded from gross income or are tax-deferred regardless of the taxpayer's use of such income. For example, interest income on qualified State and local government bonds generally is exempt from Federal income taxation. Taxation of income credited to life insurance or annuity contracts ("inside buildup") is deferred until distributed to the policyholder; such income is not taxed if paid to a designated beneficiary after the death of the insured individual (in the case of a life insurance contract). In addition, taxation of income earned on amounts contributed to an individual retirement arrangement (IRA) or an employer-maintained qualified pension plan generally is deferred until the amounts are distributed to the owner of the IRA or to the employee participating in the employer-maintained plan.

Taxation of interest accruals on U.S. Series EE savings bonds may be deferred by cash-basis taxpayers as long as the bonds are not redeemed.

Explanation of Proposals

S. 1817 (Senators Kennedy and Pell)

Exclusion

S. 1817 would provide an exclusion from gross income for the interest income earned on a qualified U.S. savings bond if the bond is transferred to an eligible educational institution as payment for the higher education expenses of a taxpayer, or taxpayer's spouse or dependents. The amount of exclusion allowed for a taxable year would be the lesser of (1) the amount that otherwise would be includible in gross income by reason of such transfer, or (2) amount of such higher education expenses.

The exclusion would be phased out for a taxpayer with adjusted gross income (AGI) of $75,000 or more for the taxable year; no amount could be excluded by a taxpayer whose AGI is $150,000 or more. For a taxpayer with AGI between $75,000 and $125,000, 67 percent of the eligible amount could be excluded; for AGI between $125,000 and $150,000, 34 percent of the eligible amount could be excluded. The phase-out amounts would be indexed in calendar years after 1988.

Only one-half of the dollar amounts described above would apply in the case of a married individual filing separately. With respect

to a taxpayer who is a dependent of another taxpayer, the phase-out would be applied by taking into account the AGI of both taxpayers.

Transferability of U.S. savings bonds

The ability to effect a transfer of a U.S. savings bond for the educational purposes of the bill would be made possible by amending 31 U.S. Code section 3105, which provides the Treasury with authority to prescribe the conditions, including restrictions on transfer, relating to the issue of U.S. savings bonds. The amendment relates to both the transfer of a qualified U.S. bond to an eligible educational institution and the redemption of such a bond by an eligible educational institution.

Definitions

A qualified U.S. savings bond means a U.S. savings bond issued at discount under 31 U.S. Code section 3105, after the date of enactment.

Higher education expenses means tuition and fees required for enrollment or attendance at an eligible educational institution, and fees, books, supplies, and equipment required for courses of instruction at an eligible educational institution. An eligible educational institution means (1) an institution of higher education described in section 1201(a) or 481(a) of the Higher Education Act of 1965, or (2) an area vocational education school as defined in subparagraph (C) or (D) of section 521(3) of the Carl D. Perkins Vocational Education Act, which is in any State (as defined in sec. 521(27) of such Act).

A dependent means any child of the taxpayer with respect to whom a deduction is allowed under section 151 for the taxable year.

Effective date

The provisions would apply to transfers of qualified U.S. savings bonds issued after the date of enactment.

S. 1662 (Senators Dole, Chafee, Danforth, Durenberger, Heinz, and Wallop)

Authority to issue bonds

S. 1662 would authorize the Treasury to issue educational savings bonds, in addition to the other forms of U.S. savings bonds. As is the usual case with Series EE savings bonds, the interest on educational savings bonds would be accrued until redemption, which could not occur less than 12 months, nor later than 20 years, after issuance. The bonds would not be transferable.

When issued, an educational savings bond would bear interest at a rate equal to the Federal long-term rate (i.e., for debt with more than nine years to maturity) in effect at the time. The rate could be adjusted upwards from the rate in effect at the time of issue from time-to-time to reflect the differential between such rate and the rate on other debt obligations issued by the Treasury.

Interest exclusion from

Under the bill, a taxpayer could purchase annually for the benefit of a dependent up to $1,000 of educational savings bonds on which interest would accrue tax-free.

Interest or investment yield on an educational savings bond would be included in the gross income of the taxpayer for the taxable year in which the bond is redeemed only to the extent that the amount of such interest exceeded the sum of the higher education expenses paid or incurred by the taxpayer with respect to a dependent for that taxable year, or if the bond was redeemed more than 25 years after the date of its issuance. This limitation would not to apply for any taxable year during which the educational savings bond is redeemed if the registered owner is disabled or the taxable year is ended by the death of the registered owner.

Definitions

Higher education expenses.—This term means expenses at any eligible educational institution for tuition and fees for enrollment or attendance; fees, books, supplies, and equipment required for courses of instruction; and a reasonable allowance for meals and lodging while in attendance.

Eligible educational institution.—This term means (1) an institution of higher education as described in section 1201(a) or 481(a) of the Higher Education Act of 1965, or (2) an area vocational education school as defined in subparagraph (C) or (D) of section 521(3) of the Carl D. Perkins Vocational Education Act which is in any State (as defined in sec. 521(27) of such Act).

Effective date

The provisions would apply with respect to taxable years beginning after December 31, 1986.

Administration proposal

The President's budget proposals for fiscal year 1989 include a recommendation to exclude from gross income the interest on certain U.S. savings bonds that are redeemed to pay certain post-secondary educational expenses of the taxpayer or the taxpayer's spouse, children, or other dependents.

The exclusion would be phased out for taxpayers with adjusted gross income above certain levels; the phase-out levels would be adjusted annually for inflation beginning in 1990. The amount of interest eligible for the exclusion would be limited to the total qualified educational expenses incurred. The Administration has not yet forwarded to the Congress a more detailed explanation of this proposal.

The exclusion would apply to bonds issued after December 31, 1988.

B. Education Savings Accounts

Present Law

Present law does not provide a specific deduction for amounts contributed to a trust to fund educational expenses of the taxpayer or a child of the taxpayer.

Education expenses that qualify as trade or business expenses under section 162 generally are deductible. Expenditures made by an individual for his or her own education generally are deductible if incurred for education that (1) maintains or improves skills required by the individual's current employment or other trade or business, or (2) meets the express requirements of the individual's employer or the requirements of applicable law or regulations imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation (Treas Reg. sec. 1.162-5(a)). In the case of an employee, such expenses (if not reimbursed by the employer) are deductible only to the extent that, when aggregated with other miscellaneous itemized deductions, they exceed two percent of the taxpayer's adjusted gross income.

Under prior law, educational assistance provided by an employer to employees pursuant to an educational assistance program meeting certain requirements was excludable from the employee's gross income or wages for income or employment tax purposes (sec. 127). This exclusion expired for taxable years beginning after December 31, 1987.

Explanation of Proposals

S. 1533 (Senator DeConcini)

In general

Under S. 1533, an above-the-line deduction would be allowed (up to certain limits) for amounts paid in cash during the calendar year to an education savings account for the benefit of an eligible individual. (An education savings account could not be established for the benefit of more than one individual.) No deduction would be allowed for contributions to an account for the benefit of an individual who reached age 19 before the close of the year.

The deduction would be limited to the lesser of (1) $1,000 or (2) the compensation (earned income in the case of a self-employed individual) includible in the taxpayer's gross income for the year. In addition, the deduction would be reduced for taxpayers with adjusted gross income (AGI) above certain levels, similarly to the phase-out of the IRA deduction. The phase-out would begin at AGI of $40,000 in the case of a married couple filing a joint return, $25,000 in the case of an unmarried individual, and zero in the case of a married couple filing separate returns.

Contributions made to an education savings account by the due date of the taxpayer's return would be deemed to have been made on the last day of the prior year.

Requirements

Under the bill, an education savings account would have to satisfy the following requirements: (1) aggregate contributions in excess of $1,000 for one year could not be accepted; (2) the trustee must be a bank or other person who would administer the trust in accordance with the requirements of the bill; (3) trust assets could not be invested in life insurance contracts unless certain requirements are satisfied; (4) the taxpayer contributing to an account generally would be permitted to direct the investments of the account; (5) the assets of the trust could not be commingled with other assets except in a common trust fund or common investment fund; and (6) any balance in the account remaining when the individual for whom the account was established attains age 27 (or, if earlier, when such individual dies) must be distributed proportionately to the taxpayers who have contributed to the account.

The account could be established only to fund educational expenses, defined to mean expenses incurred at an eligible institution for (1) tuition and fees, (2) fees, books, supplies, and equipment required for courses, and (3) a reasonable allowance for meals and lodging. An eligible educational institution means an institution of higher education (within the meaning of secs. 1201(a) or 481(a) of the Higher Education Act of 1965) or a vocational school (within the meaning of secs. 521(3)(C) or 521(3)(D) of the Carl D. Perkins Vocational Education Act).

Tax treatment of distributions

Under the bill, except in the case of distributions used exclusively for education expenses of the individual on whose behalf the account was established, any amount paid or distributed from an education savings account is included in the gross income of the taxpayer who contributed to the account, in the same proportion as the taxpayer's contribution bears to total contributions to the account. An exception would be provided for certain contributions in excess of the deductible limit returned before the due date of the taxpayer's tax return for the taxable year of the contribution.

In addition, an additional income tax of 10 percent would apply if a distribution from an education savings account is not used in connection with the payment of educational expenses, unless the distribution is made after the death or disability of the individual on whose behalf the account was established.

Tax treatment of accounts

An education savings account generally would be exempt from Federal income tax, but would be subject to the tax on unrelated business income of exempt organizations (sec. 511). An education savings account would cease to be exempt from taxation if (1) the account engages in a prohibited transaction (within the meaning of sec. 4975) or (2) the individual on whose behalf the account is established pledges all or any portion of the account as security for a loan.

Gift tax treatment

The bill provides that contributions made by a taxpayer to an education savings account would not be treated as a gift of a future interest in property to the extent that the contributions are deductible by the taxpayer.

Reporting requirements

The trustee of an education savings account would be required to make such reports as may be required by Treasury regulations. A $50 penalty would be imposed for each reporting failure unless shown to be due to reasonable cause.

Effective date

The bill would be effective for taxable years beginning after December 31, 1986.

S. 1659 (Senators Dole, Chafee, Danforth, Durenberger, Heinz, and Wallop)

In general

This bill includes provisions for educational savings accounts that generally are the same as the provisions in S. 1533, as described above, with the following exceptions.

S. 1659 would provide a 15-percent tax credit, rather than a deduction, for contributions up to $1,000 per year to an educational savings account. The maximum amount allowable in one year as a credit would be $150, allocated proportionately among the taxpayers contributing to the account; the limitation would be indexed for inflation. Under S. 1659, contributions to the account could be made in cash or in the form of stocks, bonds, or other securities, if such stocks, etc., are readily tradeable on an established securities market.

Under S. 1659, as under S. 1533, an individual could not be the beneficiary of more than one education savings account. The bill provides that no credit would be allowed for a contribution to an education savings account if, before the close of the year in which the contribution is made, the beneficiary has attained age 21 or begun attendance at an eligible educational institution. Any balance remaining when the individual for whom the account was established attains age 25 (rather than age 27, as under S. 1533) or, if earlier, dies is required to be distributed proportionately to the taxpayers who have contributed to the account.

Tax treatment of distributions

Under S. 1659, the gross income of a beneficiary of an education savings account would be increased by 10 percent of the amounts paid or distributed from the account that were used exclusively to pay the educational expenses incurred by the beneficiary, for the taxable year in which the beneficiary attains age 25 and in each of the following nine taxable years. If the amounts credited to the account are not used for educational purposes, then, as under S. 1533, amounts distributed from the account are includible in the gross income of the recipient and are subject to an additional 10-percent income tax.

Tax on excess contributions

Under S. 1659, in the case of contributions to an education savings account that exceed the allowable contributions, the excess contributions would be subject to the excise tax on excess contributions to an individual retirement account (sec. 4973).

S. 1660 (Senators Dole, Chafee, Danforth, Durenberger, Heinz, and Wallop)

This bill is the same as S. 1659 except that no credit or deduction would be allowed for contributions to an education savings account. Earnings on amounts contributed to such an account generally would be excluded from income unless distributed for noneducational purposes.

S. 1661 (Senators Dole, Chafee, Danforth, Durenberger, Heinz, and Wallop)

This bill is the same as S. 1659 except that, for each taxable year, a 15-percent tax would be imposed on the taxable income of an education savings account, i.e., the gross income of the account minus any deductions directly allocable to such income.

C. National Education Savings Trust

Present Law

Under present law, there is no provision that permits deductions for amounts contributed to a trust to fund education expenses of the taxpayer or a child of the taxpayer.

Explanation of Proposal

S. 1572 (Senators Pell, Kennedy, and Stafford)

In general

Under S. 1572, a taxpayer would be allowed an above-the-line deduction for certain amounts paid in cash pursuant to an advance tuition payment plan agreement entered into between the taxpayer and the National Education Savings Trust (the "Trust"), a public corporation established by the bill. Payments made by the taxpayer would be placed into a fund managed by the Trust to provide for future postsecondary education expenses (at a public or private institution) of a qualified beneficiary designated by the taxpayer. Amounts paid by the Trust to meet a qualified beneficiary's expenses at a postsecondary educational institution would not be includible in the taxpayer's income or the beneficiary's income.

Deduction limitations and phaseout

A taxpayer would be permitted to enter into more than one advance tuition payment plan agreement to provide for future educational expenses of more than one qualified beneficiary. However, the bill limits the amount a taxpayer could pay to the Trust under each advance tuition payment plan for each qualified beneficiary to $2,000 for any taxable year, and $48,000 for all years.

The bill further provides that amounts paid by a taxpayer to the Trust during the year would be deductible in full only if the taxpayer's adjusted gross income (AGI) for that year is not more than $25,000. If the taxpayer's AGI is more than $25,000 but not more than $60,000, then 50 percent of the amount paid to the Trust would be deductible. If the taxpayer's AGI is more than $60,000 but not more than $100,000, then 25 percent of the amount paid to the Trust would be deductible.[2] These amounts would be indexed for inflation beginning after 1988.

A taxpayer with AGI exceeding $100,000 would not be allowed any deduction for amounts paid to the Trust during that year. However, income earned on nondeductible payments to the Trust would still be tax-free, provided that such income is used to pay for postsecondary education expenses of a qualified beneficiary.[3]

The bill requires that the beneficiary of an advance tuition payment plan agreement must already have been born and must be either the taxpayer who entered into the agreement or a dependent of the taxpayer (within the meaning of Code sec. 151). In addition, no deduction would be allowed for payments made to the Trust if: (1) the beneficiary dies or attains age 30 during the year; (2) the taxpayer making the payment is a dependent of any other person; or (3) the beneficiary is the spouse of the taxpayer, unless the taxpayer and spouse file a joint return for the year the deduction is claimed.

Deductions for amounts paid to the Trust would be allowed whether or not the taxpayer itemizes deductions. A taxpayer would be deemed to have made a payment to the Trust on the last day of the preceding year if such payment is made on account of the preceding year and is made by the due date for filing the taxpayer's return for that year.

Benefits furnished by the Trust

The bill provides that payments from the Trust to a postsecondary education institution pursuant to an advance tuition payment plan agreement would not be included in the gross income of any person. Any amount disbursed by the Trust which is not paid to a postsecondary education institution, including amounts refunded to the taxpayer on termination of the agreement (as described below), would be included in the gross income of the person receiving the payment and would be subject to income tax. Also, the recipient would be subject to a penalty equal to 20 percent of the amount received (10 percent if the beneficiary has not attained the age of 25 in the year the payment is made by the Trust). The penalty would not apply, however, if a payment is made to a person other than a postsecondary education institution by reason of the death

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[2] In the case of a married taxpayer filing a separate return, 100 percent of the amount paid to the Trust would be deductible only if the taxpayer's AGI is not more than $12,500; 50 percent of the amount paid, if the taxpayer's AGI is more than $12,500 but not more than $30,000; and 25 percent of the amount paid, if the taxpayer's AGI is more than $30,000 but not more than $50,000. A married taxpayer filing a separate return would not be allowed a deduction for payments made to the Trust if the taxpayer's AGI exceeds $50,000.

[3] While not explicitly stated, the bill apparently assumes that the Trust is not subject to Federal income tax.

of the beneficiary under an advance tuition payment plan agreement.

The term postsecondary education institution means an institution of higher education as described in section 1201(a) of the Higher Education Act of 1965.

Termination of plan agreements

An advance tuition payment plan would be terminated if (1) the beneficiary dies; (2) the beneficiary attains the age of 30; (3) the taxpayer certifies to the Trust that the beneficiary, after attaining the age of majority, has decided not to attend a postsecondary education institution or has completed as much of the course of postsecondary education as the qualified beneficiary intends to complete; or (4) other circumstances determined by the Trust and set forth in the agreement.[4] Upon termination of the agreement, the Trust would be required to refund to the taxpayer the face amount of the payments or installments, plus any interest or dividends accrued thereon. The refund would be disbursed by the Trust to the taxpayer in a single payment and would be reported to the IRS.

Board of Trustees

With respect to the Trust, the bill would create a Board of Trustees composed of: (1) the Secretary of Education and the Secretary of the Treasury; (2) five representatives of postsecondary education institutions and five members of the general public, appointed by the President with the advice and consent of the Senate;[5] and (3) one chairman, appointed by the President with the advice and consent of the Senate.[6]

The Secretary of the Treasury would be the Managing Trustee of the Board with respect to managing the assets of the Trust, which could be invested only in interest-bearing obligations of the United States or in obligations guaranteed as to both principal and interest by the United States.

The Board would be required to report to Congress on an annual basis on the operation and status of the Trust during the preceding fiscal year and on its expected operation and status during the next five years.

Effective date

The amendments to the Internal Revenue Code made by the bill would apply to taxable years ending after the date of enactment.

D. Deduction for Interest on Education Loans

Present Law

Pursuant to the Tax Reform Act of 1986, the itemized deduction for personal interest is being phased out over 1987-1990 and will be

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[4] The bill provides that the agreement may permit the taxpayer, with the approval of the Trust, to substitute another qualified beneficiary for the qualified beneficiary originally named, in lieu of termination of the agreement.

[5] These representatives and members would generally be eligible to serve no more than two terms of four years each.

[6] The chairman would be appointed for a term of five years and would not be eligible for reappointment.

wholly disallowed after 1990 (Code sec. 163(h)). Personal interest is any interest *other than* interest incurred in connection with a trade or business (other than of performing services as an employee), investment interest, interest taken into account in computing the taxpayer's income or loss from passive activities, qualified residence interest, or interest on certain deferred estate tax.

Qualified residence interest, which is not subject to the limitation on personal interest, is interest on debt secured by a security interest valid against a subsequent purchaser on the taxpayer's principal residence or a second residence of the taxpayer. For taxable years beginning in 1987, interest on such debt was generally deductible to the extent that the debt did not exceed the amount of the taxpayer's basis for the residence (including the cost of home improvements).

In addition, the law for 1987 allowed a taxpayer to deduct as qualified residence interest the interest on certain loans incurred for qualified educational or medical expenses up to the fair market value of the residence. For this purpose, qualified educational expenses meant reasonable living expenses while away from home, and any tuition and related expenses that would qualify as scholarship (under sec. 117(b)), for the taxpayer, a spouse, or dependent, while a student at an educational institution. Thus, tuition expenses for primary, secondary, college, and graduate level education were generally included in qualified educational expenses. The qualified educational expenses must have been incurred within a reasonable period of time before or after the debt was incurred. Reimbursed expenses were not treated as qualified educational expenses.

For taxable years beginning after 1987, the Revenue Act of 1987 amended the definition of qualified residence interest that is treated as deductible. Under the 1987 Act, qualified residence interest includes interest on acquisition indebtedness (up to $1 million) and home equity indebtedness (up to $100,000) with respect to a principal and a second residence of the taxpayer. No special rules apply to education or medical loans.

Explanation of Proposal

S. 628 (Senators Grassley, Danforth, D'Amato, Kerry, Durenberger, and Hecht)

S. 628 provides that interest on a qualified education loan would be deductible as an itemized deduction. A qualified education loan would be defined as indebtedness incurred to pay qualified educational expenses if such expenses are paid or incurred within a reasonable period of time before or after the indebtedness is incurred. Qualified educational expenses would have the same meaning as under the law relating to qualified residence indebtedness as in effect in 1987 (described above).

The bill would be effective for taxable years beginning after December 31, 1986.

E. Employer-Provided Educational Assistance

Present Law

General rules

Under present law, an employee must include in income and wages, for income and employment tax purposes, the value of educational assistance provided by an employer to an employee, unless the cost of such assistance qualifies (under sec. 162) as a deductible job-related expense of the employee. Amounts expended for education qualify as deductible job-related expenses if the education (1) maintains or improves skills required for the employee's current job, or (2) meets the express requirements of the individual's employer that are imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5(a)). In the case of an employee, such expenses (if not reimbursed by the employer) are deductible only to the extent that, when aggregated with other miscellaneous itemized deductions, they exceed two percent of the taxpayer's adjusted gross income. No deduction is allowed for expenses incurred to qualify for a new trade or business (e.g., for law school tuition paid by a paralegal or accountant).

Under prior law, an employee's gross income and wages for income and employment tax purposes did not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts were paid or incurred pursuant to an educational assistance program that met certain requirements (sec. 127). This exclusion, which expired for taxable years beginning after December 31, 1987, was limited to $5,250 of educational assistance with respect to an individual during a calendar year.

Section 127 required, among other things, that educational assistance provided under such a program not discriminate in favor of highly compensated employees in certain respects. The Statement of Managers for the Tax Reform Act of 1986 indicated that if the section 127 exclusion for educational assistance were extended, the new nondiscrimination rules for employee benefits added by the 1986 Act (sec. 89) were to be applied to the exclusion in lieu of the prior-law rules.

In 1984, Congress required that employers file information returns with respect to educational assistance programs under section 127 (sec. 6039D). This requirement is intended to collect data with respect to the use of such programs so that Congress may evaluate the effectiveness of the exclusion.

Tuition reduction for graduate teaching assistants

Pursuant to section 127(c)(8) (prior to its expiration), the exclusion under section 117 relating to qualified tuition reductions was made applicable with respect to graduate-level courses in the case of graduate teaching or research assistants at colleges or universities. Under the section 117 rules, as amended by the Tax Reform Act of 1986, the amount of qualified tuition reduction provided to an employee of an educational institution is includible in gross income and wages to the extent the tuition reduction constitutes payment for teaching, research, or other services (sec. 117(c)). Any amount of qualified tuition reduction (up to the amount of tuition)

in excess of such payment may qualify for exclusion pursuant to section 117(d).

By virtue of the expiration of section 127, no amount of tuition reduction for graduate-level courses is excludable under section 117(d)(2) for 1988 or later years.

Explanation of Proposal

S. 39 (Senators Moynihan, Heinz, Boren, Pryor, Matsunaga, and Riegle)

S. 39 would reinstate the section 127 exclusion on a permanent basis, effective as of the termination date of the prior-law exclusion.

F. Certain Student Loan Bonds

Present Law

Purposes for which tax-exemption permitted

Interest on State and local government bonds to finance activities of those governmental units generally is tax-exempt (Code sec. 103). Interest on private activity bonds is taxable unless a specific exception is provided in the Internal Revenue Code. Private activity bonds are bonds that satisfy one or both of (1) a private business use and private payment test and (2) a private loan test. One of the purposes for which tax-exempt private activity bonds may be issued is the financing of student loans.

Tax-exempt student loan bonds may be issued in connection with the Federal Government's Qualified Student Loan (GSL) and Parent's Loans for Undergraduate Students (PLUS) programs. Student loan bonds issued in connection with the GSL and PLUS programs are Federally guaranteed, and in the case of GSL bonds, receive a Federal interest subsidy beyond tax-exemption, so-called "special assistance payments." The Federal Government imposes limits on the incomes of individuals who may receive loans financed with bonds issued in connection with these Federal programs.

Since 1986, tax-exempt student loan bonds also may be issued to finance State supplemental student loan programs. These programs are not subject to the income limits applicable to Federally guaranteed student loan bonds.

Qualified issuers of tax-exempt bonds

In general, tax-exempt bonds must be issued by or "on behalf of" a State or local government. In addition, student loan bonds issued in connection with the GSL and PLUS programs may be issued directly by a "qualified scholarship funding corporation." A qualified scholarship funding corporation is a not-for-profit corporation organized exclusively for the purpose of issuing student loan bonds to acquire student loan notes incurred under the Higher Education Act of 1965. Qualified scholarship funding corporations may not issued supplemental student loan bonds.

Arbitrage restrictions

All governmental and private activity bonds must satisfy restrictions on the amount of arbitrage profits that may be earned and retained for the interest thereon to qualify for tax exemption. In general, these restrictions limit the period in which bond proceeds may be invested in materially higher yielding investments to (1) certain prescribed temporary periods and (2) amounts invested as part of a reasonably required reserve or replacement fund.

Bonds issued as a pooled financing (e.g., bonds used to make loans to multiple parties) generally are limited to an initial temporary period of six months. A special exception applies to student loan bonds issued in connection with the Federal GSL and PLUS student loan programs. These bonds are eligible for an 18-month initial temporary period when bond proceeds may be invested in materially higher yielding investments. This special exception, enacted in 1986, is scheduled to expire with respect to bonds issued after December 31, 1988.

Issuers of all governmental and private activity bonds generally must rebate to the Federal Government all arbitrage profits earned on investments of the bond proceeds that are unrelated to the governmental purpose of the issue. An exception permits retention of these arbitrage profits if all gross proceeds of the issue are spent for the governmental purpose of the issue within six months after the bonds are issued.

A special exception applies to student loan bonds issued in connection with the Federal GSL and PLUS student loan programs. Issuers of these bonds may retain arbitrage profits earned in the 18-month initial temporary period, described above, if the proceeds are used to pay administrative costs of the student loan program and costs of issuing the bonds. This exception applies only to the extent such costs are financed with the bond proceeds and only to the extent the issuer is not otherwise reimbursed. Interest payments by student borrowers are not treated as reimbursements for this purpose.

Additionally, under a special provision of Treasury Department regulations, costs paid from student-borrower interest payments are not taken into account in determining the yield on student loans. Thus, issuers of these student loan bonds may earn and retain an amount up to two times their administrative costs and costs of issuance without violating the present-law arbitrage restrictions. The special exemption from the arbitrage rebate requirement is scheduled to expire with respect to bonds issued after December 31, 1988.

Explanation of Proposal

S. 2149 (Senators Mitchell, Pryor, Durenberger, Boren, Danforth, and Rockefeller)

S. 2149 would make permanent the special 18-month initial temporary period when issuers of GSL- and PLUS-student loan bonds may invest bond proceeds in nonpurpose investments without regard to yield restrictions.

The bill also would make permanent the special exemption from the arbitrage rebate requirement under which issuers of these student loan bonds may retain arbitrage profits to pay administrative costs and costs of issuing the bonds.

Further, the bill would extend these two special exceptions to supplemental student loan bonds and also would authorize qualified scholarship funding corporations to issue supplemental student loan bonds.

The bill would be effective on the date of enactment.

III. ECONOMIC ANALYSIS

A. Education Savings Bonds; Education Savings Accounts; and National Education Savings Trust

A number of bills introduced in the 100th Congress would provide tax incentives for education by creating either education savings bonds (S. 1662 and S. 1817), education savings accounts (S. 1533, S. 1659, S. 1660, and S. 1661), or a national education savings trust (S. 1572). Each of these bills would provide tax incentives to encourage parents to save to finance the post-secondary education of their children. These bills would provide either deferral of, or exclusion from, tax for income that is used to finance qualified educational expenditures.

Deferral vs. exemption

Exempting income from taxation is always more valuable to the taxpayer than deferring taxation on the same income. For example, if $1,000 could be invested for 10 years to earn eight percent annually and those earnings were exempt from taxation, this investment would have accumulated $1,158.93 in interest by the end of the 10-year period. If the earnings instead were taxed annually to a taxpayer at the 28-percent marginal tax rate, the accumulated interest, net of taxes, would be $750.71 after 10 years. If the earnings were not taxed annually, but rather the tax was deferred for 10 years and assessed on the accumulated interest at the end of the 10-year period, the value of the taxpayer's net earnings would be $834.43. In this example, deferral increases the taxpayer's return by 11.2 percent over the 10-year period compared to annual taxation. Exemption is 38.9 percent more beneficial than deferral over the same period.

The benefit of tax exemption generally is greater to a higher-income taxpayer than a lower-income taxpayer, because the tax liability saved per dollar of Tax-exempt income is greater for taxpayers in higher tax brackets. The benefit of deferral depends not only on the taxpayer's current tax rate, but also on his or her future tax rate. The benefit of deferral is increased for a taxpayer who currently is taxed at a high marginal rate, but who can defer the tax liability until a lower marginal rate applies. The benefit of deferral is decreased if the taxpayer currently is taxed at a low marginal rate and defers the tax liability to a year when a higher marginal tax rate applies. In this circumstance, because of the taxpayer's low initial tax rate, the taxes deferred may actually be worth less than the taxes owed at the later date when the taxpayer is in a higher tax bracket.

Provisions of present law providing saving incentives

Present law contains various tax incentives for savings. While not earmarked for education, these incentives may provide the opportunity to save for education expenses. Given the existence of these tax-preferred savings instruments, some argue that additional savings incentives are not justified.

For example, the interest on qualified bonds issued by State and local governments is exempt from Federal income taxation. The interest on U.S. Series EE savings bonds is taxed on a deferred basis. Under certain circumstances, benefits accrued under a qualified pension plan may be borrowed or withdrawn to pay education expenses. Interest earned on a life insurance contract accrues annually (inside buildup). The interest income which has accrued to the policy is subject to taxation on a tax-deferred basis. The policy could be redeemed to pay education expenses. Alternatively, a loan against the cash surrender value of a life insurance contract can be used to pay education expenses, generally without current tax on the inside buildup. Parents can establish a trust under section 2503(c) the income of which may be taxed at lower marginal tax rates than the parents' rate; the trust can then be used to pay education expenses. In addition, assets may be shifted to children and receive the benefit of the children's lower marginal tax rates if the children are over 14 years old.

Others argue that the existing tax incentives are insufficient to encourage systematic, long-term saving for education expenses, which have risen rapidly in recent years (see Appendix, below). They argue that the national saving rate is too low and further inducements to save are warranted. Moreover, they argue that the economy would benefit from having a more educated, more skilled labor force. Incentives for education would induce more individuals to seek post-secondary education or training.

Who benefits from savings incentives for education?

The immediate beneficiaries of the tax incentives to save for education provided by the bills are parents who want to fund future education expenses of their children. By providing an exemption from income, or a deferral of tax liability, the bills generally would provide more benefit to higher-income taxpayers than to lower-income taxpayers. Individuals without any income tax liability would not receive any benefit from these proposals.

The recipients of the education also could benefit, because generally additional education or training increases an individual's earning potential. In addition, the recipients may benefit by completing their education with a smaller burden of debt than they otherwise would have incurred. However, some would argue that to the extent these incentives would not lead to more individuals enrolling in post-secondary education or training programs, there would be no benefit to the recipients since they would have obtained the training even if no such incentives were enacted

Some of the benefit of the incentives may accrue to the educational institutions and their employees, rather than to the taxpayers and their children. Some believe that such incentives, by increasing the demand for post-secondary education, would drive up

the prices that educational institutions and their employees charge for their services. To that extent, higher prices could transfer the benefit from the taxpayer to the educational institution.

The benefit the parents may receive from tax exemption or deferral can significantly increase the rate of return on saving for education. This higher return might induce parents to save money for their children's education that they otherwise would not. If so, this inducement could increase the national saving rate, leading to greater economic growth.

Equity considerations

Some believe it is inappropriate to permit any taxpayer an exemption, full or partial, for interest on savings for education. Such a full or partial exemption is equivalent to a deduction for tuition costs. They argue that such a deduction more often benefits higher-income taxpayers than lower-income taxpayers, and that it is inappropriate to extend tax incentives to save to higher-income taxpayers because they already possess the means to save for their children's education without added inducement. Others argue that the costs of education have risen for everyone and that broadly applicable tax incentives are justified.

Benefits for higher-income taxpayers could be restricted in a number of ways. The amount of the annual contribution could be limited. For example, S. 1533 and S. 1572 limit the amount of annual contributions that may be deducted and phase out the deduction for higher-income taxpayers. Similarly, S. 1817 would not permit exemption of the earnings of education savings bonds for taxpayers with adjusted gross income in excess of $150,000, and would provide only partial exclusion for taxpayers with adjusted gross income between $75,000 and $150,000. However, even for these taxpayers, the benefit of tax deferral remains.

Credits for annual contributions, rather than deductions, could be utilized. For example, S. 1659 and S. 1661 would provide a tax credit for contributions made to an education savings account of the intended beneficiary. In general, a credit provides the same reduction in tax to all taxpayers regardless of their tax rate. Depending upon the size of the credit, the credit could be more or less generous than a deduction. However, deductions and credits, if not refundable, provide no benefit to individuals who have no tax liability.

Limiting the ability of higher-income taxpayers to benefit from exemption does not necessarily remove the benefit of deferral. S. 1662 would limit the annual tax deferral for all taxpayers to the deferral of the tax which would be due on no more than $1,000 of education savings bonds.

Some who believe that the benefit of the incentives accrues to the recipients of the education feel it is unfair that the recipient does not pay tax on at least a portion of the benefits received. They suggest that some of the benefits granted to current taxpayers should be recaptured from the taxpayers' children upon the completion of their education. For example, S. 1659, S. 1660, and S. 1661 each would recapture at least part of the benefits by adding to the taxable income of the child 10 percent of the benefits, in 10 equal installments starting in the year the child reaches age 25.

From a family's perspective, these bills would provide deferral of tax liability. However, from the parents' perspective, the benefit would be one of exclusion from income, because the deferred tax would be collected from the children. If the parents view the education savings account as full or partial exclusion, the bill would provide a clear incentive to establish these accounts. If the parents take the family perspective, the benefit of deferral depends, in part, upon the rate at which the tax is deferred and the rate at which the tax is ultimately due. Most typically, children are subject to lower tax rates upon their completion of post-secondary training than their parents face. When this is true, deferral can carry a substantial benefit. The benefit of deferral will be greater if the deferred amounts are taxed at a lower rate than the rate that would apply if such amounts were included in the parents' income. When the children are subject to higher tax rates than their parents, the benefit of deferral decreases but is not necessarily eliminated.

Some would view the concept of assigning the ultimate tax liability to the children as appropriate because it is the children who receive the benefit of the education. On the other hand, assigning the tax liability to the children may increase the financial burden of young individuals. For example, $50,000 in college expenses would be assigned to the child beginning at age 25. If the child is taxed at the 15-percent marginal tax rate, tax liability would be increased by $750 per year. The child would owe $1,400 per year in additional taxes at a 28-percent marginal rate. Some would argue that this is appropriate, since a higher income could result from a greater benefit received from education. However, since the typical case is for the parents' income to exceed their children's income, this would be a regressive shift of the tax burden.

An additional consideration in taxing the educational benefit to the child is administrative complexity. One or more taxpayers may contribute to the account of a single beneficiary; the taxable portion of the benefits must be traced to the beneficiary at age 25, which is three years beyond the age at which the average college student graduates. Distributions not expended on education create a tax liability for the contributors. This could create significant enforcement burdens for the IRS, which would be required to identify the contributors to whom the tax liability applies and the portion of liability applicable to each contributor.

Savings incentives for education and the national savings rate

Some argue that, as a nation, we save too little. All the above-described bills would increase the after-tax return for savings, thereby making saving a relatively more attractive option than current consumption. As a result, the taxpayer may choose to save more. However, if the taxpayer saves with certain goals or target amounts in mind, increasing the net return to saving could lead the taxpayer to save less because the same amount could be saved with a smaller investment of principal. For example, a taxpayer in the 28-percent marginal bracket may set aside $1,300 today to help defray tuition expenses 15 years from now. If the taxpayer's investment earns eight percent annually and those earnings are taxed annually, 15 years from now his investment will be worth $3,000. If

the taxpayer could defer the tax owed on the earnings for 15 years, an investment of only $1,025 today would be worth $3,000 15 years from now. Empirical investigation of the responsiveness of personal saving to after-tax returns provides no conclusive results. Some find personal saving responds strongly to increases in the net return,[7] while others find little or a negative response.[8]

Creating new tax-favored saving arrangements does not necessarily create new saving. The higher net return and the increased awareness of the need to save for college expenses which could arise from the private market advertising for education savings accounts or the sale of education savings bonds could induce taxpayers to save more. On the other hand, the taxpayer might merely transfer existing savings accounts into a tax-advantaged education account. The proposed structure for education savings bonds, education savings accounts, and the education savings trust is similar in structure to present-law deductible and nondeductible individual retirement accounts ("IRA"). Some believe that IRAs have been responsible for new saving, i.e., saving which would not otherwise have occurred.[9] Others argue that IRAs have for the most part been financed by taxpayers either shifting funds from their existing holdings of securities into IRAs, or by placing in IRAs funds which they would have saved anyway.[10] In addition, it would be possible to finance the account with borrowed funds, in which case no net saving would occur. If a home equity loan were used, the interest on the borrowed funds would be deductible as well.

As discussed above, some of the bills would limit the ability of higher-income taxpayers to utilize fully all of the incentives. Experience with IRAs prior to the restrictions imposed by the Tax Reform Act of 1986 on contributions by higher-income individuals indicated that although many lower-income individuals contributed to IRAs, the percentage of participation was greatest among higher-income taxpayers. Higher-income taxpayers made larger contributions as well. Taxpayers with adjusted gross incomes in excess of $50,000 constituted approximately 29 percent of all IRA contributors, but accounted for more than 35 percent of 1985 IRA contributions.

Distributions for expenses other than education

It may be possible for taxpayers to use these incentives to accumulate more funds than they need to meet post-secondary education expenses. The bills establishing education saving accounts or the National Education Saving Trust would include in the income of the contributors their pro rata share of any distributions from the accounts which are not spent on qualified education expenses. In addition, each bill would provide for an additional 10-percent income tax on such distributions to recapture partially the tax ben-

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[7] *See* M. Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, April 1978, 86.

[8] *See* G. von Furstenberg, "Saving," in H. Aaron and J. Pechman (eds.), *How Taxes Affect Economic Behavior*, Brookings Instiution, 1981.

[9] *See*, Venti, Steven F. and David A. Wise, "The Evidence on IRAs," *Tax Notes*, vol. 38, January 25, 1988, pp. 411-16.

[10] *See*, Galper, Harvey and Charles Bryce, "Individual Retirement Accounts: Facts and Issues," *Tax Notes*, vol. 31, June 2, 1986, pp. 917-21.

efit or deferral for such distributions. S. 1572 would increase the additional tax to 20 percent if the distribution occurs after the named beneficiary's 25th birthday.

Establishing an account or buying education saving bonds could be advantageous for taxpayers even if they have no intention of funding post-secondary education for their children. This is because of the benefit of tax deferral that the accounts would provide. For example, for a taxpayer with a 28-percent marginal tax rate, $1,000 of income would leave $720 available after tax to be saved. If this amount is invested to earn eight percent annually and the earnings are taxed annually, at the end of 10 years the taxpayer will have $1,260.51. If, however, the taxpayer can deduct the $1,000 and accumulate the interest tax-free, at the end of 10 years he or she will have $2,158.93. After including the distribution in income, subject to the additional 10-percent tax, the taxpayer would net $1,338.54 (six percent more than if the account had not been used). The result would be different if the initial contribution is not deductible.

In both S. 1662 and S. 1817, the education savings bonds would be registered to the purchaser. The purchaser need not have children to buy the bond. If not used for qualified education expenses, the proceeds would be taxed as ordinary income in the year in which the bond is redeemed. These bonds could become vehicles for saving for purposes other than financing education, because they offer any taxpayer the advantage of tax deferral on his or her investment. While an IRA currently offers the benefit of tax deferral, a penalty is imposed for withdrawal before retirement age. As a result, these bonds should be a more preferred saving instrument.

S. 1662 would moderate this potential effect by limiting the annual tax deferral to interest on the first $1,000 of such bonds. In addition, S. 1662 would require that no interest be paid on any bond held longer than 20 years. On the other hand, S. 1662 would exempt from taxation the accumulated interest if the taxpayer died or became disabled. To the extent that taxpayers use these bonds as a general saving instrument at the expense of Federal revenues, they could operate as an inefficient means of aiding education.

Some might argue that providing the tax benefit of deferral when the proceeds are not spent on education is inappropriate. The penalties in the bills may be sufficient to keep taxpayers from using these tax preferred instruments for expenses other than education. However, the penalties also could discourage taxpayers from using these instruments. Many high school graduates do not go on to college or other formal post-secondary training. If parents established these tax-preferred accounts or purchased education savings bonds, they would not know if their children will gain admittance to college. If their children do not enroll in a post-secondary education program, the parents would be subject to the penalties. Depending upon the size of the potential penalties compared to the tax saving, this could create a financial risk the parents would not want to assume. This could lead to the accounts being established by those who are most sure that their children will be going on to college. These parents are also most likely to save for college expenses in the absence of tax incentives.

On the other hand, parents who establish accounts might more readily encourage their children to seek post-secondary training. This additional training could be valuable to the economy as a whole.

Other issues in saving for post-secondary education

Investment of the account or trust monies

S. 1533, S. 1659, S. 1660, and S. 1661 would create individually directed saving accounts. The contributor could direct the trustee to invest in stock, bonds, etc. S. 1572, S. 1662, and S. 1817 would require that proceeds be invested in Federal securities or Federally backed securities. Typically, Federal securities generate lower average earnings than corporate stock or other financial instruments. Some would argue that restricting investment to lower-earning securities would diminish the incentive effect of a savings plan. In addition, they argue that freedom of choice would allow parents to earn higher yields and thereby more easily accumulate the necessary funds to meet post-secondary education expenses.

On the other hand, Federal securities are risk-free. Funds saved for education through Federal securities are assured of having their full face value plus accumulated interest available for future education expenses. The stock market and other investments are inherently risky and neither principal nor earnings are assured; thus, parents could accumulate less money than needed for their children's education.

For many taxpayers, the interest on the education savings bonds would be exempt from tax, or at least are more favorably taxed than other income. At the same time, the interest the bonds would pay could be significantly higher than that offered by existing tax-exempt bonds.[11] If so, such bonds would provide strong direct competition for the municipal bond market. This could force States and municipalities to offer higher yields to attract lenders, thereby increasing borrowing costs of State and local governments.

Other financial aid

Children of parents who have not accumulated sufficient funds to pay for college expenses are often eligible for other financial aid, either private or governmental (see the Appendix, below, for information on Pell grants, Perkins Loans, Guaranteed Student Loans, etc.). In general, eligibility for this aid depends upon parents' current income and parents' accumulated assets. The greater the parents' income and the greater their accumulated assets, the less likely the student will qualify for financial aid. Reducing the amount or likelihood of Federal or other aid to the student imposes an implicit tax on the accumulation of assets. This might reduce the effectiveness of these bills in stimulating saving for college education.

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[11] Under S. 1662, the bonds would pay the Federal long-term rate. S. 1817 does not authorize the Treasury to issue a new series of bonds, but rather would permit purchasers to qualify by purchasing any existing Treasury issue. The Treasury currently issues, as Series EE bonds, bonds whose interest earnings are not taxable until the bonds are redeemed. Thus, the existing Series EE bonds provide the benefit of deferral.

S. 1572 explicitly would require that the proceeds of an educational savings trust not be included in any computation of Federal, State, or private financial aid. While this removes the implicit penalty on accumulation, it also means that certain programs designed to aid lower-income families may be opened to high-income families.

Some would argue that it is appropriate to ask those who are wealthier to assume a greater burden of the expense of education from their own sources. Others would respond that this encourages people not to save for their children's education but rather to rely on subsidies provided by Federal, State and private programs, and it unfairly burdens those parents who do sacrifice to save for their children's education.

Definition of education expense

In general, the bills would provide savings incentives for amounts of qualified education expenses, including tuition, fees, and reasonable room and board expenses. S. 1817 would exclude expenses for room and board. Some would argue that since parents would provide for their children's room and board if they did not go away to school, it is inappropriate to provide tax benefits for these expenses; also, it can be argued that these are not expenses incurred directly for education purposes. In addition, they argue it would be unfair because parents whose children continue to live at home do not receive the same benefit. On the other hand, expenses for room and board typically cost more if one lives away from home. For children who do not attend a local college, such expenses are necessary if they are to receive the post-secondary training.

B. Deduction for Interest on Education Loans

S. 628 would permit the full amount of interest on qualified education loans to be deducted by individuals as an itemized deduction. To the extent deductibility reduces the cost of debt associated with education expenses, this provision may reduce the cost of education and thereby make college more affordable to a greater number of individuals. Also, it is argued that student loans often impose a heavy burden on graduates at the beginning of their careers; interest deductibility under the bill may ameliorate this burden.

S. 628 would reduce education costs only to the extent that debt is incurred. Because the bill may reduce the effective cost of debt relative to other financing methods, opponents may argue that interest deductibility might encourage students to assume additional debt instead of using current earnings or previous savings for education expenses.

Further, it is argued that the deductibility of student loan interest might benefit predominantly middle- and upper-income taxpayers, since college graduates generally earn higher levels of income than individuals who do not attend college. Because educational loan interest would only be deductible by itemizers, and the percentage of individuals who itemize increases with income, higher-income taxpayers may benefit more than lower-income individuals. In addition, the value of the deduction would be greatest for taxpayers in the highest bracket. Also, the highest level of loans generally would be obtained by students who continue on with professional or graduate education and who typically would have the highest income levels during the repayment period.[12]

On the other hand, some argue that the benefits of deductibility would accrue more to lower- and middle-income individuals because higher-income individuals may not need to borrow to finance education costs. To the extent that higher-income students would borrow to take advantage of the deduction while spending their resources on other goods or services, however, this argument may not be as persuasive.

Some believe that interest deductibility is desirable to alleviate the excessive burden that student loan repayments place on some graduates.[13] To the extent any excessive burden stems from low income or unemployment rather than high levels of debt, the effect of deductibility of interest payments might provide limited relief.

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[12] The Guaranteed Student Loan (GSL) program limits aggregate loans at $17,250 for undergraduates and $54,750 for graduate and professional students.

[13] For 1984 graduates of four-year educational institutions with educational debt and who held full-time jobs the year after graduation, a third had debt repayments amounting to more than six percent of pre-tax income in the first year of repayment. Ten percent of the graduates had repayments greater than 10 percent of income. See Cathy Henderson, "College Debts of Recent Graduates," American Council on Education, December 1987.

For Federally subsidized loans, a reduction in repayment rates or increased deferments might be of greater value in reducing the burden on lower-income graduates than would interest deductibility.[14] Similarly, some argue that high debt levels and correspondingly high after-tax interest payments prevent graduates from accepting lower-paying public service jobs.

Individuals who incurred debt for educational purposes prior to the Tax Reform Act of 1986 may have expected to be able to deduct interest charges when the debt was to be repaid. Some consider the phase-out of the personal interest deduction enacted in 1986 as placing an unfair, additional burden on these individuals that could not have been expected when the debt was incurred. Others respond, however, that the phase-out applies to interest on all personal debt, not just that on student loans.

According to one study, 43 percent of graduates of four-year institutions of higher education in 1984 had borrowed money for educational expenses.[15] Of 1984 graduates who borrowed funds, the average indebtedness was $5,470. For the average debtor, interest deductibility under the bill would reduce the net-of-tax loan repayment cost by a maximum of $72 in any year when compared to present law; the maximum present value reduction in the total cost of education from the year of enrollment would be under $350.[16]

In another example, a 1987 college graduate who had accumulated the four-year GSL maximum total debt of $13,250 (under present law) would receive, from the enactment of S. 628, no more than $200 of tax benefits in any year; the present value of the tax benefits due to the bill would be less than $1,050. Likewise, the average 1987 entering freshman who borrows for educational purposes is projected to accumulate a total educational debt of $11,360.[17] The tax benefit for this 1991 graduate would not exceed $250 in the first year of repayment, while the present value of the tax benefits would be under $1,200. If the student is not able to itemize for some years of debt repayment, the benefit might be significantly lower.

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[14] The GSL program already provides several deferments, including up to two years due to unemployment and for periods of additional study.

[15] The data in this paragraph are based on an analysis of the Department of Education "1985 Recent College Graduate Survey" presented in Henderson, *supra*. The analysis omits graduates who were at the time enrolled in a further degree program.

[16] These calculations assume a nominal interest rate on the loan of eight percent, that debt is treated as a GSL with deferment until six months after graduation and a ten-year repayment period, and that in each repayment period year the borrower itemizes and is in the 28-percent marginal tax bracket. It also is assumed that the borrower graduates in four years. Present values are are calculated using a five-percent annual discount rate and using the initial year of enrollment as the base year. This makes the present value amounts comparable to total college costs discounted to the freshman year.

[17] This projection is based on an 11-percent growth in the average 1984 graduate debt level (See Henderson, *supra*).

C. Employer-Provided Educational Assistance

S. 39 would reinstate the prior-law exclusion (sec. 127 of the Code) from income and employment taxes for employer-provided educational assistance; this exclusion expired at the end of 1987. Under present law, the value of employer-provided education that relates directly to the taxpayer's current job remains excludable; however, the value of expenses of training for a new job or occupation is not excludable.

The prior-law exclusion for employer-provided educational assistance can be viewed as a means for advancing the goal of increased educational opportunities. In this view, encouraging employers to retrain employees for new jobs or careers is an efficient means to increase the skills and productivity of the workforce. Education which employers provide is more likely to be of direct economic value to both the employee and the firm. Some believe, however, that the most useful employer-provided expenditures already are excludable as job-related education expenses.

Some also could argue that the prior-law exclusion provided tax benefits in an unfair manner. An individual who incurred non-job-related education expenses directly would not be entitled to a deduction for such expenses, while an individual covered by an employer-provided plan would be able to exclude from income the same expenses.

Compared to the excludability of job-related expenses, an exclusion for all employer-provided educational assistance arguably provides a greater benefit to less-skilled individuals. Higher-income, higher-skilled employees often can more easily justify educational expenses as related to their current job while, for example, a clerk may have difficulty in justifying most educational expenses as directly related to his or her current job.

Others believe that the section 127 exclusion would favor higher-income individuals, in part because exclusions are more valuable to higher-income taxpayers. Also, the exclusion might be utilized to a greater extent by higher-income taxpayers. Nondiscrimination rules would help ensure that lower-income taxpayers also benefit, though not necessarily to the same extent.

The section 127 exclusion was viewed by some as a method to avoid considerable uncertainty for employers and employees regarding eligible job-related educational expenditures. Many believe that it is administratively difficult for taxpayers and the IRS to distinguish job-related from other educational expenses, and that the prior-law exclusion provided a useful simplification. Others believe that if the prior-law exclusion is not reinstated, the IRS could provide additional guidance defining job-related education.

D. Certain Student Loan Bonds

Exception to arbitrage rebate rules

Typically, student loan bonds are issued by qualified scholarship funding corporations or other issuers which have been specifically created to administer these programs. Generally, qualified scholarship funding corporations do not receive direct assistance from State governments. Recognizing this fact, Congress permitted these issuers to utilize arbitrage earned on their bond issues to finance their operations for a transitional period while they sought more permanent financing from the State government or other sources. Since arbitrage earnings on the issue of tax-exempt securities largely come at the expense of lost Federal revenue, this special exemption is equivalent to the Federal Government funding the operation of these independent corporations. S. 2149 would make permanent this implicit Federal funding of these independent corporations.

Some argue that Federal funding of these corporations is appropriate because they administer the operation of Federal education assistance programs (the GSL and PLUS education loans). Since the benefits derived from higher education do not accrue to any one State, but to the nation as a whole, Federal assistance to these corporations links program costs to program benefits. In addition, operating these loan programs through corporations at the State level decentralizes the administration of the programs and places it closer to those receiving the loans. This decentralization can create opportunities for experimentation at the State level and also may facilitate monitoring of the program. Permitting these corporations to finance themselves through arbitrage earnings removes their budgets from the political process and assures their continued smooth functioning.

Others argue that while the Federal Government provides interest subsidies for GSL and PLUS loans, these programs are State-administered programs which direct the loans to State residents. Since the immediate benefits are directed to State residents, the States should pay the administration costs. The purpose of these Federal programs is to utilize tax-exempt bonds to lower the borrowing costs of eligible students, not to provide an indirect subsidy to program operating expenses. Early issuance of tax-exempt bonds to maximize profits is inefficient. The cost of arbitrage to the Federal Government is greater than the revenue lost to an equal incremental issue of tax-exempt bonds used to lower student borrowing costs.

In addition, it is argued that financing the operation of these corporations by arbitrage earnings removes the administration of these programs from Federal or State budgetary oversight. Unlimited use of arbitrage earnings permits the corporations to deter-

mine their own administrative budget. Lastly, making permanent this transitional exception would establish for these private corporations more favorable arbitrage rules than those that apply to any other tax-exempt bond. For example, State and local governments are not permitted such treatment on their general obligation bonds.

Issuance of supplemental student loan bonds

States may issue supplemental student loan bonds as private activity bonds S. 2149 would permit private corporations to issue bonds which are presently the purview of the States. In addition, by extending the exception from arbitrage rebate rules to these corporations, the bill would implicitly fund the administration of State supplemental student loan program with foregone Federal revenues.

Some believe that consolidating these programs would lower overall administrative costs. In addition, exempting the State supplemental student loan bonds from arbitrage rules would further the Federal goal of providing low-cost funding for post-secondary education.

Opponents argue that while GSL and PLUS loans both carry explicit Federal subsidies and guarantees, the State supplemental student loan bonds do not. Moreover, the loans made from the proceeds of supplemental student loan bonds are not subject to the Federally mandated income targetting rules. Since the supplemental student loans are purely a State program, and do not necessarily fulfill Federal policy goals of aiding lower-income families, it may be inappropriate to finance the administration of the State program through the Federal revenue loss which arbitrage generates.

APPENDIX

Direct Aid to Students for Post-Secondary Education

Background

Throughout the 1980's, more than 12 million students have enrolled annually in post-secondary education or training programs, with approximately 80 percent enrolled in public institutions and 20 percent in private institutions. From the average high school graduating class, 65.8 percent enroll in some form of post-secondary education or training program at some point in the four years following their high school graduation. During this period, 45.2 percent attend a four-year college or university, 27.9 percent attend a two-year college, and 7.6 percent attend a vocational or technical training school.[1]

In every year since 1981, the costs of attending a two- or four-year college have risen faster than the rate of inflation; by contrast, in the late 1970's college costs lagged behind inflation. As Table 1 below details, since 1976 college tuition and fees generally have risen 30 percent more than the economy's overall price level. For the 1975–76 academic year, the total cost of attending a four-year private college averaged $4,391 (tuition of $2,240) and the total cost of attending a four-year public college averaged $2,679 (tuition of $578). For the 1986–87 academic year, the comparable total cost figure had risen to $10,199 (tuition of $5,793) for a four-year private college and to $5,604 (tuition of $1,337) for a four-year public college.

[1] Center for Education Statistics, *The Condition of Education 1987.* The subcategories do not add to 65.8 percent because an individual may be counted in more than one category. For example, a student might attend a junior college before attending a four-year college.

Table 1.—Annual Percentage Change in Average College Costs, 1976–1987

Year [1]	2-year colleges				4-year colleges				Change in Consumer Price Index (CPI)
	Public		Private		Public		Private		
	Tuition and fees	Total cost of resident students	Tuition and fees	Total cost of resident students	Tuition and fees	Total cost of resident students	Tuition and fees	Total cost of resident students	
1977	28.6	1.8	5.3	5.9	7.4	4.1	4.0	4.0	6.5
1978	0.5	3.9	4.1	2.8	0.0	4.2	6.3	5.3	7.7
1979	4.9	4.5	6.5	6.2	4.8	5.1	6.9	6.2	11.3
1980	−4.7	3.5	5.9	6.7	4.5	6.7	10.4	8.1	13.5
1981	19.3	13.1	1.8	8.8	3.8	4.6	12.2	10.1	10.4
1982	1.1	3.4	26.6	22.0	16.0	13.6	13.1	13.2	6.1
1983	26.9	10.3	−5.5	2.6	19.5	13.3	8.4	8.6	3.2
1984	4.4	8.6	24.5	15.0	12.9	7.6	15.1	12.9	4.3
1985	−3.7	3.4	10.0	6.9	1.9	3.4	8.4	6.9	3.6
1986	10.2	[2] NA	9.3	8.9	10.3	8.9	8.0	7.1	1.9
1987	0.6	[2] NA	5.1	4.7	7.6	5.5	6.9	5.6	3.7
1976–1987	120.2	[2] NA	136.7	118.3	131.2	109.2	158.6	132.2	99.6

[1] Change is measured from preceding year. Hence, 1979 measures the change from 1978 to 1979.
[2] Not available.

Source: S. Boren, "Selected Tables and Readings Related to College Costs," Congressional Research Service, September 16, 1987.

Federal direct aid to post-secondary students

Pell Grants

Pell Grants provide a foundation of financial aid, to which aid from other Federal and non-Federal sources may be added. To qualify, the student must be an undergraduate enrolled at least half-time. In addition, the student or his or her parents must satisfy a needs test based on the student's or parents' current income and accumulated assets.

The maximum award for the 1987–88 academic year is $2,100; no repayment is required. Pell Grants are usually limited to providing assistance for five years of study. Pell Grants are awarded without regard to the school the student chooses to attend.

Supplemental Educational Opportunity Grants

A Supplemental Educational Opportunity Grant ("SEOG") is an award for undergraduates with exceptional financial need, with priority given to Pell Grant recipients. As a grant, it does not have to be repaid.

The maximum SEOG is $4,000 per year. The size of the grant a student receives depends upon need and the availability of SEOG funds at the school. Financial need is determined by reference to the Uniform Methodology.[2] The Uniform Methodology makes a different calculation of need than does the Pell Grant, but like the Pell Grant bases its calculation on the student's or his or her parents' current income and accumulated assets.

College Work-Study

The College Work-Study ("CWS") Program provides wage subsidies to colleges for jobs held by undergraduate and graduate students who need financial aid. The student must be paid at least the Federal minimum wage, but may be paid more depending upon the type of work. A student's award of CWS funds depends upon need as determined by the Uniform Methodology, the availability of funds at the school, and other sources of aid.

Perkins Loans

Perkins Loans, formerly National Direct Student Loans, are low-interest loans (currently five percent) to students for post-secondary undergraduate or graduate education. Eligibility is needs-tested based on the Uniform Methodology.

The student may borrow up to $4,500 if enrolled in a vocational program or if he or she has completed less than two years of a program leading to a bachelor's degree; up to $18,000 if the student has completed two years of study toward a bachelor's degree; and up to $18,000 for graduate or professional study. This latter total includes any Perkins Loans received to finance undergraduate studies.

No payment of principal or interest is required until nine months after the student graduates or leaves school. Interest pay-

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[2] *See*, S. Boren, "Provisions of the Pell Grant Family Contribution Schedule and the Uniform Methodology As Contained in the Higher Education Amendments of 1986," Congressional Research Service, July 9, 1987.

ments may be deferred thereafter under certain circumstances, such as service in the Armed Forces. The borrower has up to 10 years to repay.

Guaranteed Student Loans

A Guaranteed Student Loan ("GSL") is a low-interest loan made to the student by a private lender such as a bank; these loans are insured by a State guarantee agency and reinsured by the Federal Government. The interest rate for GSLs commencing July 1, 1988 will be eight percent. The Federal Government pays a special allowance to lenders to bring the GSL borrower's rate up to approximately the fair market rate. Eligibility is determined by the Uniform Methodology. The GSL program is a needs-tested entitlement program, the only entitlements program in the Department of Education.

Depending upon need, the student may borrow up to $2,625 per year if a first- or second-year undergraduate student; up to $4,000 if two years of undergraduate study have been completed; and up to $7,500 per year if a graduate student. As an undergraduate, the total amount of GSL debt the student may have outstanding is $17,250. The total for graduate study is $54,750, including loans received as an undergraduate.

Loan repayments begin six months after the completion of study. Loan payments may be deferred under certain circumstances. The Federal Government makes interest payments on behalf of the student while the student is enrolled in school and during deferral periods. The lender must permit at least five years and may allow up to 10 years to repay.

PLUS Loans and Supplemental Loans for Students

PLUS loans are for parent borrowers and Supplemental Loans for Students ("SLS") are for independent student borrowers. Like GSLs, they are made by private lenders to the parents or the student. SLS and PLUS loans carry a variable interest rate, adjusted annually. The variable rate is based on the bond equivalent rate of the 52 week Treasury-bill plus 3.25 pecentage points. For the 1987–88 academic year, the interest rate is 10.27 percent. PLUS and SLS loans are not needs-based.

The loans are insured by the State guarantee agency and reinsured by the Federal Government. Unlike GSL loans, the Federal Government does not pay interest during deferral periods. The only direct Federal subsidy, aside from insuring defaults, occurs if the calculated interest rate for PLUS and SLS loans rises above 12 percent. In that circumstance, the loan rate is capped at 12 percent and the Federal Government pays a special allowance to lenders.

PLUS enables parents to borrow no more than $4,000 per year, up to a total of $20,000, for each child who is enrolled at least half-time. Under SLS, graduate students and independent undergraduates may borrow no more than $4,000 per year, up to a total of $20,000. This amount is in addition to the GSL limits.

State Student Incentive Grants

State Student Incentive Grants provide grants to those States which establish a scholarship program and use State funds to

match the Federal funds. The maximum grant a student may receive under this program is $2,500. The States establish the eligibility criteria.

Scope of direct aid to students

In addition to Federal aid, direct aid is available to post-secondary students from State programs and from private institutions. Table 2, below, shows the trend in direct aid to students since 1970. Since 1975, total aid available and institutional aid have risen roughly at the rate of overall inflation, but somewhat less than the more rapidly rising college costs. Because total enrollment in institutions of higher education has risen from 11.2 million to 12.2 million, student aid per enrolled student has not kept up with the overall inflation rate.[3]

Table 2.—Sources of Student Aid to Higher Education, Selected School Years 1970–71 to 1985–86

[In million of dollars]

Source	1970–71	1975–76	1980–81	1985–86
Federal student aid:				
Pell grants		936	2,387	3,749
SEOG grants	134	201	366	396
College work study	227	295	658	693
Perkins loans	240	460	695	841
Guaranteed student loans, PLUS, and SLS	1,015	1,267	6,201	9,411
State student incentive grants		20	76	76
Subtotal	1,616	3,179	10,383	15,166
Other Federal aid:				
Veterans	1,121	4,180	1,714	746
Social Security	499	1,093	1,883	0
Other aid	109	180	190	[1] NA
Institutionally awarded aid	965	1,435	2,138	3,426
State grant programs	236	490	801	1,374
Total	**4,495**	**10,486**	**17,099**	**21,008**

[1] Not available.

Source: S. Boren, "Selected Tables and Readings Related to College Costs," Congressional Research Service, September 16, 1987.

[3] S. Boren, "Selected Tables and Readings Related to College Cost," Congressional Research Service, September 16, 1987.

Table 2 indicates that loans are the fastest growing component of Federal aid. However, the growth of total borrowing does not necessarily imply that real indebtedness of students has increased.

Table 3 shows that while the number of students receiving Federally sponsored loans has increased substantially, the average GSL and Perkins loans, measured in constant dollars, has decreased slightly. More students are using Federally sponsored loans rather than each student taking a larger loan. On a per-student basis, this suggests that nonloan direct aid to students has declined even more.

Table 3.—Post-Secondary Student Borrowing by Program, Selected School Years 1970–71 to 1985–86

[Number of loans in thousands]

Program	1970–71	1975–76	1980–81	1985–86
Guaranteed Student Loans				
Number of loans	1,017	922	2,899	3,640
Average loan:				
Current dollars	$998	$1,374	$2,134	$2,277
Constant 1986 dollars	$2,824	$2,784	$2,770	$2,333
Perkins Loans				
Number of loans	452	690	813	854
Average loan:				
Current dollars	$532	$667	$853	$880
Constant 1986 dollars	$1,505	$1,351	$1,107	$902
PLUS Loans				
Number of loans	[1] NA	[1] NA	6	212
Average loan:				
Current dollars	[1] NA	[1] NA	$2,333	$2,585
Constant 1986 dollars	[1] NA	[1] NA	$3,029	$2,649

[1] Not applicable.

Source: J. Hansen, "Student Loans: Are They Overburdening A Generation?" College Entrance Examination Board, February 1987.

Table 4 indicates that student debt, from all sources, has risen as a percentage of college costs. In conjunction with Table 3 data, this might suggest that non-Federally sponsored borrowing has increased in importance.

Table 4.—Comparison of Cumulative Debts of 1977 and 1984 College Graduates

	1977 Graduates		1984 Graduates	
	Public	Private	Public	Private
Average cumulative debts	$2,348	$3,114	$4,970	$6,350
Average cost of 4 years of college	$10,500	$17,900	$17,100	$32,500
Debts as percentage of costs..	22	17	29	20

Notes: Based on Department of Education surveys of college graduates. Cumulative debt is defined as total educational debt from all sources. Data only includes full-time employed graduates of four-year institutions who incurred some positive amount of educational debt.

Source: C. Henderson, "College Debts of Recent Graduates," American Council on Education, December 1987.

Tax expenditures for education

Present law contains several provisions which directly benefit education and training. For example, scholarship and fellowship income is excluded from taxation (up to certain limitations). Parents may claim an exemption for students age 19 or over. The interest on State and local government student loan bonds is tax-exempt. Contributions to educational institutions are tax-deductible for itemizers, subject to certain limitations. Over the next five years, fiscal years 1989–1993, the various tax expenditures related to education and training are estimated to be worth $17.2 billion.[4]

[4] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1989–1993* (JCS–3–88), March 8, 1988.

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